

RENEGOTIATION—A CONSCIENCE FOR PROCUREMENT*

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*In matters of commerce the fault of the Dutch
Is offering too little and asking too much.*

—GEORGE CANNING

THE most significant provision of the Revenue Act of 1943 with respect to renegotiation is the cut-off: renegotiation of war contracts is to terminate on December 31, 1944, or, should the President so decide, not more than six months earlier or later than that date.¹ Quite simply, Congress has decreed that procurement officials must prepare to buy hundreds of thousands of different war products without the aid of renegotiation—the principal sanction of procurement and also its principal substitute for the economic controls of competition.

Renegotiation does serve as a sanction. A contractor who insists upon a price which appears high, who demands a profit of twenty-five per cent, or who refuses to submit satisfactory breakdowns of estimated cost—thus taking advantage of the government's desperate need—may be (and often is) told: "Very well, we need these supplies and we'll buy them at your terms, but since your demands seem unreasonable, we intend to tell the whole story to the price adjustment authorities." If the contractor does not alter his position, he will discover in renegotiation that his pricing policies are considered, and considered unfavorably, in determining a permissible margin of profit. Renegotiation is also a remedy for the war-time lack of competition—one might almost say it is a safety valve—which prevents the retention of monopoly profits by manufacturers engaged in war production. Renegotiation grew out of a nation-wide demand over a period of two decades to "take the profits out of war," and,

* "In truth, renegotiation is the conscience of procurement. The reasons for its existence are the same that produced equity to ease the rigidity of the common law. The pangs of conscience vary with circumstances. So with renegotiation." Renegotiation of War Contracts, Report of the Committee on Naval Affairs, House of Representatives, 78th Cong., 1st Sess., pursuant to H. Res. 30, at page 38.

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¹ Revenue Act of 1943, tit. VII, § 403 h.

while it has not accomplished this mandate literally, it has gone far to prevent profiteering and the consequent scandals which a majority of our citizens associate with the last war. Because of the projected termination of renegotiation, a new sanction must be devised and new—or rather more elaborate—procurement techniques must seek to secure proper prices at the outset and so prevent excessive profits from arising. In the interim, in order to prepare procurement eventually to proceed alone, renegotiation and procurement must be brought into closer relationship: they must work together to control costs and profits. The question naturally arises, can procurement ever successfully do the job alone? That question deserves discussion, but, since Congress has already answered affirmatively, it is necessary first to find out how procurement can best prepare for its ordeal.

Perhaps the most necessary change is a change in attitude on the part of procurement officials and contractors alike. For renegotiation, while it has resulted in a widespread realization that close pricing and moderate profits are to be considered desirable, has also produced the attitude that these goals need not be attained at the time a contract is negotiated. Will not price adjustment see that they are attained in due course? While some contractors are cooperating fully with the Government's efforts to purchase at close prices, others regard overample provisions for contingencies in their bids and high profit margins as justifiable protection—they want their risks as insignificant as possible. Procurement officials themselves may be lulled into a feeling of false security: they are willing to let renegotiation protect the Government from their errors and their failure to secure reasonable prices. But these attitudes are not simply incidental, though unlooked-for, consequences of the Renegotiation Act. They go much deeper. Fundamentally they indicate a failure to realize that costs and concern about costs have something to do with efficient production. These simple truths are overlooked and a purely mechanistic theory of war production preferred, even by those who support the profit-motive economy, on the ground that it maximizes efficiency of production and therefore production itself. Stated crudely, the mechanistic theory runs something like this: give the producer what he wants by way of contract terms and prices, don't disturb him by inquiring into his internal controls, don't question his cost estimates, and above all don't frighten him by the fear of loss, for production is simply an engineering problem of getting the materials, working them on machines, and assembling them into final products. Prices and costs and all the paper work they involve are at best necessary red-tape that can just as well (no, better!) be taken

care of after the items are delivered to the Government. They must not be allowed to interfere with production!

Of course, no one is likely ever to spell out such a theory, for, to quote Mr. Justice Holmes, "practical men generally prefer to leave their major premises inarticulate."² The fact is that our entire economy would become hopelessly snarled if businessmen, both buyers and sellers, did not pay attention to comparative prices and costs, for that attention is essential to the functioning of market machinery which determines the distribution and utilization of the factors of production. Efficient production, as the economists use the term, means distribution of those factors among producers and their employment by each producer in such a way as will maximize utility. In wartime, utility must necessarily be related to the demands of the government for war goods. If one manufacturer's scrap losses are inexcusably high, he is depriving the government of some item it needs; thus wartime utility is clearly not maximized. To be efficient, therefore, the individual manufacturer must utilize his labor and materials without waste, or, to put the same thought another way, he must keep to a minimum his material and labor costs per unit.

Uncontrolled costs mean wasted material and manpower. In peacetime a manufacturer who wastes them loses ground competitively and eventually loses his shirt, as the bankruptcy figures testify. In wartime, with essential materials and manpower so scarce, it is of the utmost military importance that costs be controlled, and the surest way to guarantee this result is to make the manufacturer's return dependent upon it: award him a contract at a price calculated to cover costs and leave an adequate profit, provided he controls costs and keeps waste to a minimum. The contractor's natural incentive to maximize profit should do the rest: to make a profit at all, he must do a good job; to increase that profit he must do an excellent or a superlative job; but if he falls down—if he wastes any critical molybdenum or rubber or tin, or if he makes the manpower shortage worse by hoarding labor—his anticipated profit will shrink or disappear altogether. Where, however, the contractor is guaranteed an overgenerous profit from the start, incentive is absent. Since the profit-motive economy normally implies an ever present threat of economic death to spur each producer, it is a strange logic indeed which urges removal of that pressure in wartime on the ground that it will impede production.

To see how renegotiation can serve as the connecting link between the early, immature procurement methods, which inevitably resulted in in-

² Collected Legal Papers 209 (1920).

adequate pricing and unconscionable profits, and the procurement of the future which must try to emulate normal competitive controls without renegotiation, it is necessary first to study the problem historically: (I) What economic circumstances made contract pricing so difficult and renegotiation so essential? (II) What techniques has renegotiation developed which are of such importance to procurement?

I

The prices the Government pays for most war goods are monopoly prices, and the profits realized by the suppliers are monopoly profits. For, despite the fact that the Government is the only buyer, the market is a seller's market, with each seller something of a monopolist. The war has created such a need for military supplies of all kinds that even marginal and submarginal producers can sell at a handsome profit everything they can turn out. Each manufacturer's product is in a sense unique: he is the only one who can produce it; as a portion of the war's requirements, the Government must have it. There being no other supplier, there is no competition, and consequently price has almost nothing to do with equating the forces of supply and demand. In contrast to the limitation placed upon a peacetime monopolist by effective demand in the market, the war monopolist can often assume that demand is infinite, that he can sell all he can produce. Hence there is no need for him to think (as the economists' monopolist is said to think) in terms of how to maximize his return—either by setting the price high and selling a relatively small quantity or by restricting quantity and letting demand bid up the price. Price and sales volume are virtually independent variables.

It is true that an element of competition has remained. Although the Government relies almost exclusively upon negotiation rather than upon competitive bidding, it is customary to solicit proposals from a number of concerns before "negotiating" a contract with one of them, perhaps the low bidder and frequently not. But the effective area for such "competition" is severely restricted, for procurement is decentralized to a great extent, and within the particular geographical area assigned to a local procurement office there may be only a very few producers capable of producing a given item. Further, with more than enough business to go around, all the producers who submit proposals may receive contracts, regardless of how their prices compare. Not infrequently price is a very secondary consideration. Questions of manufacturing capacity and experience, ability to meet production schedules, labor supply—all are of greater importance than price. The military necessity for speed in procurement and produc-

tion has often precluded paying too much attention to price. All of which made good sense.

Even if there had been the time and the inclination to scrutinize proposals carefully in the early days of the war, there would not necessarily have been an opportunity to analyze cost estimates intelligently. Many war products were new and unusual, had never been produced before, and called for working with strange materials and to very close tolerances. Often they had absolutely nothing to do with the normal peacetime operations of a contractor: former refrigerator manufacturers, stovemakers, gasoline engine assemblers, and radio companies are all making ordnance fuses. Consequently, both the would-be producer and the Government had to guess at costs, and this guessing game was made all the more difficult by the Government's reserving the right to make changes in specifications and schedules at any time. As a final unsettling element, negotiation might precede production by as much as six or eight or ten months. These factors made for great fuzziness in cost estimates and for the inclusion of allowances for contingencies ordinarily more than sufficient to meet probable increases in costs and other hazards.

Subject to these qualifications there was an opportunity for bargaining between the parties. The Government might properly seek to bring a price down when it seemed badly out of line (with other prices arrived at in the same fashion), or it might insist upon the insertion of a pricing article which would permit readjustment of the price after production information indicated how high the original estimates had been.

It is in keeping with the fitness of things and the writings of political scientists on sovereignty to think of negotiation with the Government as a process of treating with Donald Nelson or Robert Patterson, whose authority to deal firmly with a private company can, if need be, find support from the White House itself. Surely in such a situation the hapless businessman is in a poor bargaining position. Surely the Government holds all the aces. In practice, however, this picture requires modification, for in fact everything from 'the deuces up may be wild. Far from the Government's being in a position always to overawe the contractor, the reverse is often the case. The civil servant or second lieutenant who actually does the negotiating for the Government cannot throw much weight around. He must conform to generally accepted procurement customs which place great emphasis upon serving the contractor and assisting him in working out his problems. His job frequently becomes routine, for the volume of work to be handled makes impracticable devoting sufficient time and facilities to analyzing the contractor's estimates, and no matter how long

the negotiator sticks at the game he will never know as much about the contractor's business as the contractor does. Then, too, he may encounter company officials—particularly those of certain large and influential concerns—who consider local procurement offices as bothersome obstructions to be by-passed. And he may be afraid to tempt the company into appealing over his head, for fear that he will not be supported by his superiors. Under these circumstances it is a bit difficult to feel sorry for anyone having to sell to the Government. Selling in a seller's market to a customer who needs everything you have to offer and who, in any event, is in a poor administrative position to bargain, is just a little like taking candy from babies.

Excessive profits are thus natural. Even if the market had been less of a monopolist's paradise, even if the Government had not deliberately reduced the risks of war producers far below the level of normal peacetime risks,³ even if cost estimates had been estimates and not guesses, excessive profits would still have arisen. For the Government purchased item by item, contract by contract, ten thousand dollars today, eight hundred thousand tomorrow, and fifteen million next week. A producer who thought in terms of a sales volume of five million for the year might at any moment be asked to double production on one item and triple output on another. And one procurement agency alone can be responsible for such a circumstance. The producer, however, can sell to six or seven branches of the Army, the Navy, the Maritime Commission, and a few others as well. Consequently no one purchasing agency, much less one negotiator charged with procurement, ever has the faintest idea of the overall effect of war contracting on a company's costs and profits.

The producer himself was only slightly less confused. His volume might balloon far beyond his fondest hopes and so permit him to spread his relatively fixed overhead expenses against many times the estimated dollars of sales. Calculating in January that his annual volume would reach five million dollars, he might apportion one-fifth of his estimated general and ad-

³ The Government has devised special short-cut contracts to enable contractors to begin work prior to entering into definitive agreements; furnished an enormous amount of machinery and tooling; utilized special pricing articles designed to afford protection against unexpected cost increases; devoted a great deal of attention to contract provisions and procedures for saving contractors whole in the event of termination or changes in specifications and schedules; expanded the concept of excusable delay; provided working capital through advance payments and V loans; and set up a system for extraordinary relief under the First War Powers Act and Executive Order 9001. It is safe to say that the risks of prime contractors, at least, have been more than adequately taken care of.

A detailed treatment of the subject of risk distribution in procurement contracts will be found in an article by the author and Lt. David Fain entitled *War Procurement—A New Pattern in Contracts*, in 44 Col. L. Rev. 126 (1944).

ministrative expenses to a contract for one million dollars. By June, however, he might be shooting for a ten million volume and so charge a tenth of his newest estimate of general and administrative costs to the latest contract for a million dollars. When December rolls around, it is not unlikely that the company's government contracts have covered these expenses for the year two or three times over. The surplus naturally shows up as profit. While material and direct labor costs per item can be estimated with some assurance, factory overhead or burden, and more especially general and administrative expenses per item, have no reality except as they develop over a fiscal period. With volume so uncertain, the natural tendency is to overestimate these costs on each contract, even apart from any deliberate inclusion of allowances for contingencies.

The Government has initiated policies designed to remedy many of these shortcomings. To a limited extent, moreover, the changed circumstances of the market have placed it in a better bargaining position: on certain items for which the need is not critical, procurement agencies can now pick and choose among producers; and the increasing number of terminations—which reflect the shifting requirements of war—give the Government an opportunity (in theory at least) to cancel out the high-price and relatively inefficient producers. Greater emphasis is being placed upon analysis of the contractor's proposals, especially his breakdown of estimated cost, which can be compared with the actual results on his previous contracts and with the operations of comparable contractors. His price can be compared with that currently proposed by others. The difficulty is that the standards are uncertain, there being so many different factors which affect the real price to the Government as contrasted with the money price: volume, government-owned equipment, government financial assistance, special pricing articles for adjusting the contract price in light of actual production experience, free-issue material, mandatory changes which alter the specifications, and shifts in schedule. Just because two companies produce the same item for the same price does not mean that the Government has an equally good bargain with each of them. Yet weighing the factors that affect the real price is not easy: which is better for the government—a \$5.00 unit price subject to upward as well as downward revision or a \$5.00 price not subject to revision but which contemplates the Government's furnishing free-issue material valued at \$0.13 per unit? It must be remembered, too, that comparing one price with another price or with a range of prices only establishes its relative correctness in terms of that price or that range, the worth of which must be proved by some outside standard. A \$5.00 price in a range from \$4.98 to

\$6.12 seems reasonable. But it is most unreasonable if the range should be \$3.22 to \$4.36. The outside standard necessarily must have something to do with the question—how much should it cost contractors A, B, C, D, and E to produce this item, considering their capacities, skills, contemplated volumes, and all the other relevant factors? To answer requires a study of costs in each plant far more exhaustive than the press of war procurement ordinarily allows.

The excess-profits tax is definitely no solution, even with a top bracket of ninety-five per cent, subject to an overall ceiling of eighty per cent.⁴ The factor of sales volume is so striking that even though a company can keep only twenty-eight cents of every dollar of profit (including postwar credit), enough money comes in to leave it with profits which, expressed in terms of net worth, are shocking. As an example take a company whose average sales for the period 1936–39 were less than a million, whose average profit before taxes for that period was less than six per cent of sales, and whose largest net profit (after taxes) was just \$50,000. In 1940 sales increased to \$1,500,000 and profits to ten per cent, in 1941 to \$4,400,000 and twenty-five per cent. Profits after taxes were \$90,000 in 1940 and \$34,000 in 1941. In 1942, however, the company's sales rose to \$23,000,000 (almost one hundred per cent war work), profits before taxes to \$8,000,000, and profits after taxes to over \$2,000,000, which represented a return of approximately 300 per cent on net worth. It must be noted, moreover, that net worth at the beginning of 1942 was at least double the average net worth for the 1936–39 period, chiefly because of the large profits the company earned on war work in 1940 and 1941. And in 1942 the par value of the outstanding capital stock was only \$225,000. To be sure, this is an extreme case, but the recent report of the minority of the Senate Finance Committee indicates that there are hundreds of similar cases.⁵

In these circumstances, renegotiation or something like it was a political must. The worst by-products of emergency procurement, indefensible profits, had to be recaptured and their recurrence made less likely. "The real choice is between renegotiation and war profiteering."⁶ Renegotiation has successfully weathered at least three Congressional investigations, and each time it has emerged strengthened despite unrelenting efforts to secure its emasculation or repeal. It is an integral part of a farflung assault upon inflation. It is as necessary to our wartime economy as rationing. It is indispensable to our fighting morale.

⁴ The provision for postwar credit of ten per cent of the excess-profits tax makes the actual ceiling about seventy-two per cent.

⁵ S. Rep., Part 2, 78th Cong., 1st Sess. at 15–16.

⁶ *Ibid.*, at 4.

Since renegotiation was originally drafted as a pricing measure, and since its administration made it appear a supertax, many of its opponents have condemned it with a sweeping "either-or" type argument: it must be either a pricing measure or a taxing measure; experience demonstrates that it concerns itself primarily not with prices but with refunds of profits already made; therefore, it is a tax. Since it obviously lacks the standards essential to sound taxation, it should be repealed. Unfortunately for this conclusion that renegotiation is a tax, it just isn't so. Renegotiation is not a taxing device; it is not designed to raise revenue; and as a matter of fact, the less its honest enforcement turned back to the Treasury, the happier everyone would be, inasmuch as the absence of refunds would be at least an indication of proper prices. Just because renegotiation takes money from war contractors does not make it a tax, any more than a contract redetermination article which requires a refund in the event of overpricing is a tax.

Renegotiation does not fit neatly into any category. Essentially it is a pricing measure, even though for administrative reasons it has operated chiefly on the profit rather than on the cost aspect of prices, and on overall war profits rather than on profits on particular items or contracts. Inflated profits necessarily mean inflated prices, although it does not follow that adjustment of the profit downward achieves the correct price, for costs may be inflated as well. But it is unquestionably easier to operate on profits. It is easier to determine that a company's profit is too high than to conclude that its maintenance and repair expenditures are unreasonable. Equally important, the job of adjusting a contractor's prices item by item, contract by contract, would have been nearly impossible, since it is not unusual for one manufacturer to be supplying half a dozen different agencies of the Army and the Navy, and the variety of the products may be startling—all the way from mess trays to landing mats to high-explosive shells. If each procurement agency undertook to reprice its own items, the poor contractor would be harried indeed, although at the same time he would have a golden opportunity to juggle costs as between one contract and another. Consequently, it was inevitable that renegotiation should be undertaken on an overall basis, that it should look at the entire operation for a fiscal year to see how much profit the contractor made on all his war business. If the profit appears too high, renegotiation reduces it and persuades the contractor to reduce prices so as to prevent unreasonable profits in the future. One additional reason for this approach needs mention. The vast majority of war producers perform most of their war work on a subcontract basis, they are often far removed from the procure-

ment agencies, and their operations and products are not known at first hand. To adjust their prices item by item would be harder by far than to try repricing by that approach on prime contractors. And many are suppliers of substantially the same items they made in peacetime, selling according to standard price lists through wholesalers and jobbers. There is an understandable inclination on their part—although not therefore a defensible one—to maintain those price lists unchanged, despite increased volume and higher profits. Overall recapture certainly afforded a more feasible way to deal with these producers.

When a contractor refunds \$500,000, his sales to the Government as well as his profits are reduced by that amount. The effect is thus to reduce the end-price to the Government by cutting the profit on the total quantity of items purchased from that contractor during the year, and the total end-price is cut regardless of whether the company produces only one item or a great variety of products. Of equal importance, renegotiation operates on subcontractors and suppliers all the way down the line. Taking excessive profits from them further affects prices, for what these subs and suppliers charge are costs to prime contractors. And, although it is not true in all cases, many renegotiation agreements oblige contractors and subcontractors to reduce their prices in order to prevent the recurrence of excessive profits. For example, let us assume that X, a prime contractor charging \$10.00 for a war product, purchases a component part from Y for \$2.00. Both X and Y refund excessive profits and agree to reduce their prices. As a result of these adjustments at the prime and subcontract levels, the new price to the Government reflects a reduction not only of X's profit but also of his costs.

What is more, profit percentages allowed in renegotiation tend to serve as ceilings for estimated profit in new contracts. Some contractors still insist upon a comfortable profit cushion, ordinarily in the form of contingency allowances, but many are taking their contracts on closer margins, realizing that they cannot keep profits above a certain amount. It must be emphasized, however, that simply because a contractor was allowed ten per cent in renegotiation is no reason for awarding him new contracts on an estimated ten per cent profit basis. Perhaps the easier, more routine continuation orders should be pared down to five per cent, whereas newer and more risky ventures should go forward on an estimated twelve or fifteen per cent profit basis.

It is not simply coincidence that the first really considerable reductions in the prices of many war products occurred after contractors began to feel the effects of renegotiation, along in the first half of 1943. At that

time a large number of the principal prime contractors made substantial renegotiation refunds and reduced current prices, and others, realizing that their turn was next, made voluntary refunds and forward price reductions in order to establish presentable records to show to the price adjustment boards. These voluntary reductions continued throughout 1943. Consequently, any estimates of the total savings accomplished by renegotiation cannot stop at refunds and reductions in current prices required by renegotiation agreements; they must also include the voluntary price reductions and the scaling down of prices on new awards, which were largely due to the awareness of contractors that renegotiation would get the money sooner or later anyway. Thus to renegotiation must go a large share of the credit for the substantial unused appropriations recently reported by the War Department.

This discussion offers an appropriate occasion for a few comments on one of the most confusing (perhaps deliberately so) arguments about renegotiation. Critics have constantly asserted that renegotiation should be after taxes—that it should be frankly recognized as a supertax and so review a contractor's profits after he has paid his taxes. A refinement of this position asserts that federal income and excess profits taxes are really operating costs like wages and depreciation. Figures have been concocted to show that profits after taxes (expressed in percentages to sales) were really smaller in 1942 and 1943 than in any of the pre-war years. Not only does this argument ignore the volume factor, it tries to pass over the fact that wartime tax rates are at all-time highs.

The real result of the after-tax approach would be to have the Government pay the contractor's income and excess profits taxes as part of the contract price, for taxes would be added to costs, and profits would be something in addition. The increased price of war goods would just equal the revenue received through income and excess profits taxes from war contractors, and the real cost of these items would have to be paid by other means. If procurement and renegotiation operated in this fashion, the excess profits tax would be inflationary with a vengeance, for in the entire war-goods field it would automatically result in higher prices. But aside from wholesale avoidance of the tax burden by war contractors, renegotiation after taxes would mutilate the Government's effort to purchase scientifically and at proper prices. If, for a given item, material, labor, burden, and a properly allocable portion of general and administrative and selling expense total \$0.93, and an additional \$0.07 is considered proper for estimated profit, the price to the Government should be \$1.00, not \$1.00 plus a portion of the contractor's tax liability. The taxes to be

paid by the contractor have nothing to do with the question of a fair price to the Government. Differences in the tax bases of contractors ought not lead to different prices for their products (assuming the other factors to be equal), and any tax inequity as between companies should be remedied, not through renegotiation, but through appropriate changes in the revenue laws. Furthermore, to allow in the contract price an item of cost to cover the contractor's taxes would require a remarkable degree of clairvoyance, for taxes are not known until the end of a year, whereas contracts must be awarded currently and prospectively throughout the year. Worse yet, the excess profits tax is a tentative tax subject to revision in later years.⁷ And finally, the efforts of renegotiation to reward the efficient would be fruitless if the primary determining factor were the contractor's tax base.⁸

Quite rightly, renegotiation officials have asserted that it is the job of Congress to determine who shall bear the burdens of war taxes and how great those burdens shall be. War contractors are already more fortunately placed than many individuals in our society—the soldier who gave up his job or business or professional practice, the manufacturer who could not adapt his plant to war work, the owner of a service-station. To give them now the extraordinary privilege of relief from part or all of their tax burden would be inexcusable. There is no doubt that some producers have deliberately upped their prices in order to absorb increased tax rates. If they were selling to private parties, the effect would be to shift the incidence of the tax, much as sales taxes are shifted, even those phrased as retailers' occupational taxes. But when the principal customer is the Government, the effect is to nullify the increased tax rates. It is baffling indeed that otherwise staunch defenders of Congressional prerogatives should be almost eager for the will of Congress to be flouted so obviously.

II

The value of renegotiation as a procurement device lies chiefly in its ability to review the results of a completed fiscal period and thereby to assess the performance of the contractor and, necessarily, that of procurement officials as well. Such an appraisal is invaluable to future contracting,

⁷ The loss carry back and special amortization spread back provisions, among others, make likely extensive adjustment of taxes after the war.

⁸ Under present tax rates renegotiation cannot rectify tax inequities. An efficient producer with an inadequate tax base will inevitably be worse off after taxes and renegotiation than a mediocre producer with a very fortunate tax base. Psychologically, therefore, the reward to the efficient must be in terms of profits before taxes.

both because of the vantage point of renegotiation and because of the type of data utilized by renegotiation.

Renegotiation looks at the contractor's war business as a whole, and not contract by contract. Thus renegotiation officials can see what effect war business has had on the nature of the contractor's operations and his volume, and the effect of that volume on his costs and methods of controlling costs. The contracting officer who awards one contract at a time is in no position to envisage these overall consequences. The engineering and fiscal personnel of any one procurement office are similarly handicapped.

Renegotiation affords an opportunity to compare the contractor's performance with that of others engaged in the same type of war production. This follows naturally from the effort in renegotiation to have the same price adjustment section handle similar manufacturers; and in each individual section, comparable companies may be assigned for renegotiation to the same negotiator and financial analyst. Thus renegotiation may permit determining for the first time which contractor is really the low-price and low-cost producer—bearing in mind all the special factors which make such judgments difficult.

Renegotiation permits studying the contractor's method of pricing on government business, and especially the means by which he allocates general expenses to that business. Actual cost figures which indicate that these expenses are markedly lower than the contractor has consistently estimated constitute a basis for insisting that the contractor reduce these allocations on future bids. Glaring inconsistencies between results and estimates may indicate that the contractor does not take seriously the job of pricing or that his cost system is hopelessly inadequate or out-of-date for the job. It may even happen that the contractor is not aware of his deficiencies on that score. His becoming aware of them through renegotiation can lead to a thorough overhaul of his entire costing and pricing system.

Renegotiation in most cases can secure costs by products and even by contract, which apart from renegotiation are difficult to obtain. Thus procurement officials can learn from production experience what would have been a proper price for an item, and such knowledge is a necessary starting point for future awards. It serves, moreover, as a check upon the reliability of the particular contractor's estimates, and product costs submitted by different contractors can be compared and possible sources of savings suggested by the differences disclosed.

Renegotiation affords the first occasion when financial and operational

data can be assembled, correlated, and analyzed. Problems and answers both, which otherwise would remain buried, can be uncovered: an inefficient producer's troubles may show up in high scrap losses, in unnecessarily high overhead charges, or in labor costs out of proportion to those required by other producers of the same item. The producer whose production record is poor or erratic is almost always the producer whose costs are not controlled, and that fact will show up in the financial data submitted for renegotiation. Production and procurement personnel may have their own ideas as to the trouble prior to renegotiation, but only operational figures can definitely disclose many of the most likely causes of inefficiency.

Renegotiation looks at specific cost items, particularly those which are under the direct control of the management. For example, a contractor may be maintaining a large sales force, including branch offices. Although such a force is only remotely connected with war business, the contractor may be charging to every contract a portion of the amount needed to cover its maintenance. The company may have instituted an executive bonus arrangement which pays unreasonable sums to the principal officers. It may appear that the contractor is throwing into cost estimates amounts for accelerated depreciation greater than those to which he is entitled, or he may be incurring unnecessary repair and maintenance expenses. Thus the costs charged to government business are subject to scrutiny. If they appear questionable, renegotiation can demand and secure explanations. If the explanations are not satisfactory, renegotiation agencies acting under the original act could disallow as charges against renegotiable business all expenses beyond reasonable amounts. The amendments just enacted require that deductions for tax purposes permitted by the Bureau of Internal Revenue be allowed as costs for renegotiation.⁹ Inasmuch as renegotiation for 1943 will take place long before the bureau has audited 1943 tax returns, renegotiation agencies must now judge what the bureau will and will not allow, and they can take into account unreasonable salaries and costs in determining what is a permissible margin of profit. Certainly the contractor who controls controllable costs should be rewarded and the contractor who inflates these charges penalized.

Renegotiation can give recognition to the element of risk. A contractor who consistently contracts at a high margin, with a very comfortable

⁹ "Notwithstanding any other provisions of this section, all items estimated to be allowable as deductions and exclusions under Chapters 1 and 2 E of the Internal Revenue Code . . . shall, to the extent allocable to such contracts and subcontracts . . . be allowed as items of cost. . . ." Revenue Act of 1943, tit. VII, § 403 (a) (4) (B).

cushion as protection against possible cost increases, is taking very little, if any, risk. He should therefore be entitled to little beyond a management fee, much as the cost-plus-a-fixed-fee contractor is paid. By and large the holder of a prime contract is well protected against most of the risks of doing war business. A subcontractor or supplier, on the other hand, may incur a very substantial risk through greatly expanded inventory. By giving effect to such variations in risks, renegotiation can relate risks to pricing.

Renegotiation can tackle the problem of the pyramiding of profits. A completed item entails extensive subcontracting: each major subcontractor decentralizes his part in the production job to sub-subs, who likewise farm out part of the work, and so on through several more tiers of subcontractors and suppliers. Each contractor in the series takes a profit, with the result that the total amount of profit earned by all constitutes a large portion of the end-price of the item. By scaling down the profits of subcontractors and suppliers, renegotiation can successfully reduce profit on profit.

Renegotiation can help evaluate certain procurement policies. It should be of assistance, for example, in determining whether contracting on a short-term basis and scheduling continuation orders to maintain uninterrupted production results in lower prices (as it should) than does a policy of awarding contracts for six months' or a year's requirements. It should likewise reveal whether the inclusion of an upward-downward price adjustment article really leads to the elimination of most contingency allowances (as it should).

Renegotiation can uncover true hardship situations which require the immediate attention of procurement officials. Occasionally a company becomes badly overextended through large investments in fixed assets needed to expand production. Especially in the case of a subcontractor dealing with many prime contractors working for different procurement agencies, such hardship circumstances may escape the attention of procurement personnel. But renegotiation cannot fail to encounter them, although it is far from able to provide a cure.

Finally, renegotiation can supply incentive. It is the announced policy of the renegotiation agencies to reward the efficient low-cost and low-price producer, and a conscientious effort is made in practice to achieve this end; recognized efficiency does receive a higher allowable profit percentage. Many contractors may need reminding that claiming efficiency and demonstrating efficiency are two entirely different things. But more, by starting war producers on the road to close pricing, renegotiation can

make it important for contractors to control costs and thus can become one instrument for the application of pressures which ordinary peacetime competitive conditions supply. So long as prices provide sufficiently ample protection against risks, contractors will tend to be indifferent to the prices they pay suppliers and will fail to see any need to control costs within their own plants. Renegotiation operates initially on profits, seeking in that manner to affect prices first and then costs, but it can also influence costs more directly. In both ways it can and should help restore the pressures which stimulate the manufacturer's drive to efficiency.

Of the various points just mentioned, four especially merit further discussion, particularly since they throw light on the importance of renegotiation as a distinctive vantage-point in the procurement process: (1) the study of the contractor's cost system; (2) the analysis of product costs; (3) the scrutiny of particular costs; and (4) the attack on the pyramiding of profits.

Renegotiation interests itself in a contractor's cost system in the course of determining whether the allocation of costs between renegotiable and non-renegotiable business is fair and reasonable. Since it is to the contractor's interest to make his profit on renegotiable business appear as low as possible, he may allocate costs with that end in view. Consequently, examination of the method used in the allocation along with the cost system which presumably led to or justified that method is essential. The first problem pertains to the cost of sales:

The cost of sales is departmentalized by the company. The direct labor cost incurred in each department is actual and is allocated to the product directly. Direct material charges are computed from invoices supported by both subassembly and final assembly cost sheets and are then recorded on the cost department copies of each sales invoice. Factory burden is computed by departments under three classifications: direct manufacturing groups, indirect service departments, and functional expense groups. The first classification is allocated monthly to the general product groups on the basis of direct labor. The two latter classifications are allocated to the producing departments on the basis of service rendered, power consumed, etc.

This excerpt from a report of renegotiation should be of value to procurement officials in considering future proposals from the company, since it indicates that the company maintains product costs, and estimates based upon that system should be reliable. Furthermore, such information can be of very real assistance to the contracting officer when he must determine the adequacy of a contractor's cost system as a prerequisite for the use of a periodic price adjustment article. Certainty that the contractor's system is good is most necessary when part of the contract may be exempted from renegotiation. Or consider the following:

The method used in determining costs by products is the same as has been employed by the company for many years. It is a shop order system whereby products were put through in lots of several thousand per order. Direct labor is on an actual cost basis, as is direct material. Factory burden is applied on a standard rate basis using both a general rate for the entire plant and departmental rates on a productive hours basis. As there has been very little difference between the commercial business conducted by the company and the manufacture of items which now have government end-use, it is felt that this method is applicable to the company's normal products. The contractor gained considerable experience in producing Ordnance items prior to 1942, so that the standard rates did not have to be adjusted materially at the end of the year. The adjustment which was made arose from the fact that standard factory overhead exceeded the actual factory overhead during 1942.

From this it appears that the contractor employs standard burden rates which are quite close to actual rates, largely because of the continuity of production. Where, however, changes in a manufacturer's operations make necessary substantial adjustment of standard rates at the year end, renegotiation and procurement personnel might appropriately suggest that the contractor review and revise his cost system. One contractor, for example, admitted that his main office had taken a heavy loss by transferring component parts to a branch office at costs based on out-of-date standard rates.

General and administrative and selling and advertising expenses are generally allocated on some more or less arbitrary basis. In the course of this allocation particular expenses such as provisions for bad debts, salesmen's commissions on commercial business, and insurance premiums can be allocated directly to non-renegotiable business:

Selling and advertising and general and administrative expenses were allocated between renegotiable and non-renegotiable business on the basis of cost of sales, as were service expenses, engineering, and experimental expenses. Royalties were allocated as a direct cost to the product to which they applied. A provision for bad debts was charged entirely to non-renegotiable business.

An alert procurement negotiator could use this brief statement in any analysis of future cost breakdowns.

Of even greater importance are product costs. Procurement is frequently unable to obtain complete breakdowns on previous contracts, for contractors say that they do not accumulate costs by product or that they are too busy to be bothered. In renegotiation, however, it is relatively easy to determine whether such detail is obtainable, and even if the contractor does not utilize product costs for purposes of internal control, he may be able to compile the figures upon request. Only rarely will he persist in balking when requested by a price adjustment board. The following discussion of a particular allocation problem is enlightening:

The question of cost allocation presented an extremely difficult problem. The sudden increase in profit in 1942 provided reasonable ground for assuming that the profit on renegotiable sales was substantially higher than on commercial sales. The company submitted evidence that in its normal commercial product prices had risen from forty per cent to sixty per cent in 1942 over 1941. The financial analyst and the negotiator were satisfied that part of the unusual profit on commercial sales was due to the liquidation of inventory, the value of which had been understated or had risen sharply as a result of the change in market conditions in 1942 as compared with previous years.

The company engaged independent accountants to make a study of the time and material costs of the principal war product. In the opinion of the financial analyst and the negotiator, this study was honestly, accurately, and conscientiously made.

Here, surely, cost information was obtained which normal procurement procedures could not secure, even if the item had been on a prime rather than a subcontract.

Comparison of product costs for a completed fiscal period with the breakdown on a proposed award does not solve problems—rather it suggests questions. For example:

	1942 Experience	1943 Proposal
Materials.....	\$143.52	\$162.92
Labor.....	75.78	82.03
Burden.....	82.61	83.64
Administrative.....	7.92	7.92
Total costs.....	309.83	336.51
Profit.....	63.77	37.40
Price.....	\$373.60	\$373.91

At first sight the new price appears satisfactory. Examination reveals, however, that the estimate for materials has increased 13.5 per cent and for labor 8.2 per cent. The estimated profit is 10 per cent. Since actual production results show a profit of 17.07 per cent, it is certainly possible that the increased estimates for labor and materials are not justified by likelihood of higher costs, and that they were upped primarily for the purpose of making the contemplated profit appear moderate. At the very least, the procurement negotiator should investigate. The estimate for administrative expenses should likewise be checked, for analysis by the price adjustment section revealed a consistent decrease ever since the Government took over the entire production of the plant, thus permitting a large reduction in selling costs, and comparison of actual costs with earlier estimates revealed consistent overestimating. The new proposal, moreover, is based upon an anticipated increase in production.

In the following instance the company submitted a series of proposals for virtually its entire war production for the coming year:

	1942 Production (After Renegotiation*)		1943 Proposal	
Materials.	\$1,417	57.1	\$ 8,076	64.2
Labor.	258	10.4	1,261	10.0
Burden.	381	15.4	1,552	12.3
Engineering.	64	2.6	126	1.0
Administrative.	151	6.1	567	4.5
Royalties.	11	0.4
Cost.	2,282	92.0	11,582	92.0
Profit.	198	8.0	1,006	8.0
Price (sales).	\$2,480	100.0	\$12,588	100.0

* 000 omitted. The figures are shown after renegotiation in order to remove the element of price inflation represented by excessive profits. This adjustment permits comparing the ratios to sales of cost items in 1942 with the ratios in the 1943 proposal.

The proposal contemplates about five times the 1942 volume. By converting 1942 material costs to the greater volume, the historical material cost becomes \$7,191,000 as compared with the \$8,076,000 stated in the proposal. Since it seems reasonable that a close relationship will be maintained between material costs and sales, despite increased volume, this cushion of nearly \$900,000 in the material cost estimate requires further investigation. The estimate of \$1,552,000 for burden probably contains contingency allowances, for the fixed items in burden should increase only moderately, even if the variable items increase in direct proportion (which is improbable), and the fixed items comprised approximately one-fifth of the 1942 total. The estimate for administrative expenses, although smaller percentagewise, shows a large dollar increase. This cannot be justified inasmuch as the bulk of these expenses in 1942 consisted of executive compensation.

Offhand it may appear that renegotiation contributed little or nothing to this analysis, for procurement personnel ordinarily obtain cost breakdowns on completed contracts, and these figures can be compared with a new proposal without utilizing renegotiation experience. The point is, however, that unless so-called actual costs for a previous period or contract are tied into the overall operating statement of the company, they are of questionable reliability. Only the overall approach of renegotiation can make certain that the allocation of costs to a particular product or contract is justified. Otherwise the contractor's "product costs" may be no more than an arbitrary statement designed to suit best his interests of the moment.

Renegotiation occupies an especially strategic position with respect to the scrutiny of costs, particularly those under the direct control of the management. Not only is it the one occasion when the detail of such accounts as advertising, executive compensation, depreciation, and repair and maintenance can be secured; it affords the only opportunity for applying a counterpressure to the forces which cause most contractors to regard these expenses indifferently, or even to increase them deliberately. With corporate tax rates so high, it makes good sense (from a contractor's point of view) to push allowable tax deductions to the limit; this is especially true when the prices that the company is receiving for its products are more than ample to cover ordinary costs. Increased advertising expenses, if the bureau approves, thus become a wonderful investment—at a net cost of roughly twenty cents on the dollar. Or take salaries. Here it is not only to the company's interest tax-wise to up salaries, it is to the officers' interests too. Even to maintain after-tax income requires substantial salary increases, but many companies have contrived to provide their officers with larger after-tax incomes, despite the higher personal tax rates.

The House Naval Affairs Committee was properly aroused:

We were somewhat disturbed to find that the Departments do not make a more searching review of the expenditures of contractors. In view of the fact that one of the prime functions of renegotiation is the scaling down of prices by the disallowance as charges to the Government of improper items of cost, we think that the Price Adjustment Boards should devote more of their time to making a careful examination of the facts upon which the financial statements submitted by the contractors are based.¹⁰

Although the recent amendments to the act apparently restrict the authority to disallow expenses, renegotiation is far from powerless, since it can take into account high salaries in determining a reasonable profit. For example, in analyzing the profits of a closely held corporation whose principal stockholders and principal executives are identical—and by and large such cases provide most of the flagrant salary increases—one may properly add the ratio of profit to sales to the ratio of salaries to sales. If ten per cent is considered a fair settlement where salaries total three per cent of sales, a comparable company (all other factors, such as volume, contribution, and efficiency, being similar) where salaries are six per cent should certainly be settled somewhere near seven per cent. Otherwise the company which upped salaries unreasonably comes off the winner.

And renegotiation officials can state bluntly what they think of unreasonable salaries, even though they do not believe that the bureau will

¹⁰ *Supra*, note *, at 30-31.

actually make disallowances. They can inform the company that if it continues with such expenditures, it can expect far less favorable treatment the next time it is renegotiated. This approach is clearly applicable to the whole of general and administrative, and selling and advertising expenses, and already there is sufficient evidence with respect to 1943 cases to conclude that it can bring results. As the problem is simply one of reorienting the contractor's ideas as to where his interests lie, it is clearly part of the larger one of pressures and incentives. One of the distinct virtues of renegotiation over any straight tax scheme yet suggested is its ability to exert pressures and stimulate incentives to control costs.

Renegotiation has the tremendous advantage of dealing directly with subcontractors and suppliers whom the procurement agencies ordinarily never see. Since purchased materials and components often account for more than half of the total prime contract price, examination of the prices paid up and down the line is essential to a real pricing program. Even if the only element of inflation were the profit, the opportunities for reducing the price of the end-item would be considerable; but if both the profit and cost approaches are utilized in renegotiation, and if proper administration stimulates the desired incentives, the opportunities are truly tremendous. The renegotiation of 1942 cases suggests that the average overpricing approximates 10 per cent of the sales price (taking into account clearances as well as refund cases and prime contractors and subcontractors alike).¹¹ Thus, on an average, if it be assumed that 10 per cent is a fair profit margin, every contractor in the production chain is getting 20 per cent. Let us translate this into an example:

	Price*	Profit	Excessive Profit
Supplier.....	50	10	5
Tool company.....	100	20	10
Subcontractor.....	150	30	15
Prime contractor.....	200	40	20
.....		100	50

* These figures are intended to represent dollar prices. Thus the tool company pays the supplier \$50, the subcontractor pays the tool company \$100, the prime pays the sub \$150, and the Government pays the prime \$200.

The total profit realized by the four producers in this series is \$100 out of an end-price to the Government of \$200. By recapturing 10 per cent of

¹¹ If clearances are eliminated, the average over-pricing is around 16 per cent. Renegotiation of War Contracts, Hearings before the Committee on Ways and Means, House of Representatives, 78th Cong., 1st Sess., at 97.

excessive profits from each producer, a total of \$50 is taken, thus reducing the end price to \$150, on which the total profit taken by the four is only \$50. With a chain of six producers the pyramiding is much greater:

	Price	Profit	Excessive Profit
Supplier.....	50	10	5
Subcontractor.....	100	20	10
Tool company.....	150	30	15
Subcontractor.....	200	40	20
Subcontractor.....	250	50	25
Prime contractor.....	300	60	30
.....		210	105

Here the total profit is \$210 out of a price of \$300. A 10 per cent reduction in the profit of each producer cuts the price by \$105 to \$195.

As a matter of fact these hypothetical cases are relatively mild. Many instances are available of a series of producers, each of whose profits are inflated by far more than 10 per cent. Unfortunately these series are difficult to trace, and only rarely does one renegotiating agency have the entire chain subject to its jurisdiction. The following examples, though incomplete, are in point:

	PERCENTAGE OF EXCESSIVE PROFITS TO SALES
Subcontractor.....	25
Prime contractor.....	23
Tool steel company.....	12
Tool company.....	21
Prime contractor.....	15
Forging company.....	17
Subcontractor.....	55
Subcontractor.....	unknown
Cost-plus-a-fixed-fee prime contractor.....	6.12

As might be expected, the subcontractors under the cost-plus-a-fixed-fee prime contractor are overpricing to the greatest extent. The cost-plus prime contractor, his costs being guaranteed, feels no need to buy carefully. In fact if he did, his costs might drop so sharply that his fixed fee would appear too large percentagewise, a probability which the following instances of overpricing by subcontractors and suppliers under a cost-plus

prime make clear. The prime here was in direct buying relationship with these companies, which thus were first-tier subcontractors:

SUB- CONTRACTOR	PERCENTAGE OF EXCESSIVE PROFIT TO SALES
A.....	31
B.....	29
C.....	26
D.....	28
E.....	30
F.....	38

Clearly renegotiation often provides information for judging the purchasing efficiency of a prime contractor. It should not be assumed that only cost-plus contractors are careless buyers. Fixed-price prime contractors can and do have sufficiently large cushions in their prices to enable them to adopt an easy-going attitude toward the prices which they pay to subcontractors and suppliers. There are cases of prime contractors paying a sub for an item double the price the Government is paying for the same item under a prime contract. There are also instances of prime contractors refusing price reductions proffered by their subs.

Here is a field where procurement personnel are handicapped by their established policies of dealing with prime contractors only. But renegotiation can and must utilize its extensive experience among subcontractors to force down prices and call forth the incentives which will make each producer in the chain from prime contractor to the lowest subcontractor fully conscious that careful buying is essential. Admittedly this complicates the job of renegotiation. But unless this task is undertaken, costs and profits on subcontract items will remain high long after prime contract profits have dropped to an apparently reasonable level—apparently reasonable because the end-price will still be too high, and pyramiding, although less obvious, will continue.

III

It is apparent that renegotiation as a technique has a great deal to contribute to procurement. One cannot be sure, however, that its peculiar advantages and the information obtained through its operations have been fully utilized. To date there has been insufficient pressure upon procurement officials to obtain close prices, and renegotiation itself has served to reduce that pressure.

The contemplated termination of renegotiation puts the matter square-

ly up to procurement officials: Can they carry on without the protection which renegotiation affords? Can they obtain fair prices on the vast majority of items they must buy? Can they adapt their purchasing procedures and contract forms to the job of ensuring that excessive profits will not arise? The action of Congress has thus gone far to restore needed pressures. Procurement officials now know that they must rely on their own abilities and techniques and that they cannot forever count on renegotiation to serve as a backstop for wild pitches and foul balls. While it continues, therefore, renegotiation must work closely with procurement in a joint effort to control profits, to cut costs, and to furnish the necessary incentive to contractors to keep costs low.

In general terms, it would seem that procurement officials must orient their thinking toward the accomplishment of the following immediate goals:

1. *The fullest possible utilization of the results of renegotiation.* This means that procurement negotiators must study the reports of renegotiation and the work papers which lie behind.

2. *The development of a new sanction.* Conceivably in some instances procurement may be able to force a recalcitrant contractor into line by threatening to place no further orders with him. In other instances, however, where the particular contractor's production is essential and consequently where his bargaining power is great, the judicious use of the mandatory order is called for.

3. *Realization that the responsibility for fair prices and moderate profits lies solely with procurement personnel.* It will no longer do for procurement negotiators to think lightly of any inadequacy or carelessness on their part.

4. *Careful scrutiny of comparative cost and comparative price data.* This means going into considerably greater detail than has been customary. Renegotiation reports for one or two years will in most instances be available, and these will indicate the type of costs that the contractor has incurred and may currently be charging to government business.

5. *Concern with the overall effect of war contracting on the operations of the contractor.* In the case of a contractor whose major war work is with one procurement agency, this problem is not insoluble. But where a company is both a prime contractor for many different agencies and a subcontractor or a sub-subcontractor for many different primes, it will be extremely difficult for any one procurement agency to visualize the overall effects of its policies and practices on that company. The interrelationship of the prices and costs of the different items made by one manufacturer must

constantly be kept in mind. For example, cancellation of a tank contract will result in an increase in the cost of a contractor's artillery carriages and landing ships, due to the necessity for increased absorption of fixed overhead.

6. *Close relationship between estimated profit margins and the risks of the contractor.* If the item is a difficult one which calls for precision work, the contractor is properly entitled to a higher return than is a contractor manufacturing a simple item which he intends to subcontract extensively. Although it is generally true that the provisions of prime supply contracts are fairly uniform, there are variations which substantially affect the risks taken by the contractor. Where a contractor takes risks as a result of conscientious close pricing, relief should be given him if he does encounter uncontrollable hazards that take away his reasonably anticipated profit.¹²

7. *Exploitation of the present more favorable market conditions.* The Government now has substantially greater bargaining power than it had during the emergency phase of procurement, while terminations and cut-backs afford it an opportunity to cancel out the inefficient and high-price producer. A policy of selective awarding and cancelling of contracts will have a direct effect on the incentive of producers. The stabilization of the requirements for many items, moreover, makes possible an increased element of competition in war procurement.

8. *Increased use of contracts providing for exemption from renegotiation.* Procurement must really be sure of its ground in these cases, however, and such certainty can come only from a successful attempt to work along the lines already suggested.

Renegotiation, in turn, must set for itself certain immediate goals which complement the current aims of procurement:

1. *Speedier processing of cases.* Efforts are now being made to complete renegotiation cases within three months. Although this is a most difficult goal in complicated cases, greater speed must be obtained in order that the pressure on the contractor to reduce prices, backed up by historical cost data, is instituted as soon as possible after the conclusion of a fiscal year.

2. *Securing of product costs.* In no instance should renegotiation be carried on without an effort to obtain accurate historical costs by product. Where current costs are available, these too should be secured.

¹² It is the policy of Headquarters, Army Service Forces, to utilize relief under the First War Powers Act and Executive Order 9001 in such a manner as to encourage close pricing. See Fain and Watt, *op. cit.* *supra* note 3.

3. *Forward pricing.* Greater emphasis must be placed upon the securing of specific price reductions in every case where the results for the prior year indicate that present prices will probably result in excessive profits. If a detailed revision of prices cannot be obtained, a general covenant to reduce prices wherever possible should be included in the renegotiation agreement. It might even be advisable to discuss prices, prior to discussing recapture of excessive profits already realized. The problem will naturally be much easier in the case of a contractor who manufactures a relatively small number of items under contract with one procurement agency. Where a contractor is renegotiated by one agency and prime contracts are outstanding with other agencies, cooperation between the renegotiating agency and the other services or Departments must be established. Pricing and repricing necessarily must be accomplished in close cooperation with procurement personnel, and in fact the War Department is presently undertaking a pre-renegotiation experimental pricing program. Its principal aim is to introduce procurement personnel to the complex problems and techniques of war contract pricing under circumstances permitting close cooperation with renegotiation and the selection of the companies to be dealt with. It may also serve to initiate pricing discussions prior to formal renegotiation proceedings.

4. *Relation of subcontract items to the end-price (the prime contract price) paid by the Government.* Many of the most glaring instances of excessive profits are realized by manufacturers of component parts and supplies going into end-products. Since these items may pass through the hands of other subcontractors before reaching the prime contractor, the possibilities for pyramiding profits are excellent. Where possible, the entire series of producers must be considered together and measures taken to ensure that price reductions by one subcontractor in the chain are passed along by the other subcontractors above him and by the prime contractor to the Government.

5. *Penalizing of contractors whose pricing practices and profit margins are unreasonable.* A man who insists upon a thirty-three per cent profit or a thirty-three per cent cushion of profit plus contingencies has eliminated virtually all risks from his operations. It is not sufficient that he is willing to refund a large portion of that cushion at the end of the year, as, his risks having been reduced, his incentive to efficiency has likewise been all but eliminated. Nor can a contractor in this situation get a clean bill of health by making voluntary price reductions or refunds to the Government toward the end of the year. Voluntary reductions are significant only if their timing indicates a real intention to operate under close prices. A

contractor who has reduced his risks to a minimum is entitled to little more than a management fee, no larger than that paid a cost-plus-a-fixed-fee contractor.

6. *Closer attention to the elements of controllable cost in price.* Contractors must be made to realize that unnecessary expenditures are not an un-mixed tax advantage.

These or similar policy developments are necessary if the goal which Congress believes can be achieved is to be achieved. Congress has supplied the necessity. It remains now to be seen whether renegotiation and procurement will reorient their policies and procedures in order to permit renegotiation to come to an end without serious danger of national scandal.

A strong argument can be made for the proposition that no matter how expert procurement becomes, some method of overall review, such as renegotiation, will continue essential. Constant changes in the quantities and in the very products required by global war inevitably make cost estimates problematic, and there is as yet nothing to indicate that government requirements are about to decline sharply. Consequently, the restoration of competitive conditions, which, Congress believes, will make continued renegotiation unnecessary, is most unlikely.¹³

But, apart from this circumstance, it must be remembered that certain elements in factory overhead, together with most general and administrative, and selling and advertising expenses, have no reality as costs per item except as historical costs per item. Even as historical costs they must be determined by an arbitrary method of allocation which the Government, as the principal buyer, should have the right to review. Any estimate of this type of expense as to a given product is necessarily guesswork, in contrast to the reasonably ascertainable estimates of direct material and direct labor costs. As a result, the contractor takes the natural precaution of overestimating. This factor alone can, and does, lead to excessive profits. At some stage in the procurement process, therefore, companies must be viewed as operating units over a past period, whereas decentralized procurement as presently constituted functions for

¹³ "(2) The term 'termination date' means—

"(A) December 31, 1944; or

"(B) If the President not later than December 1, 1944, finds and by proclamation declares that competitive conditions have not been restored, such date not later than June 30, 1945, as may be specified by the President in such proclamation as the termination date;

"(C) If the President, not later than June 30, 1945, finds and by proclamation declares that competitive conditions have been restored as of any date within six months prior to the issuance of such proclamation, the date as of which the President in such proclamation declares that competitive conditions have been restored"; Revenue Act of 1943, tit. VII, § 403 h.

the most part prospectively and always on an individual-contract basis. It is doubtful, moreover, whether any one procurement agency ever can successfully undertake an historical review from the overall vantage point which renegotiation now occupies. If it did, it would become a renegotiating agency. The largest and most successful buyers among our private enterprises, *even when able to dictate terms and prices in advance*, have found most desirable a brand of "renegotiation" as a means of adjusting prices in light of historical profits and costs. The public interest demands that the Government as a buyer be no less diligent.

Accepting renegotiation as indispensable does not mean placing war procurement on a cost-plus basis. For renegotiation can influence costs and make disallowances, and it can determine a reasonable profit to be anything from two to twenty-five per cent of sales. It thus provides the essential incentive for the increased production, quality, operating efficiency, and control of costs needed to win the war, to check inflation, and to help save the peace. In fact, enlightened self-interest should lead business to support renegotiation. If, because of the easy-come, easy-go circumstances of war procurement, large numbers of companies become careless about costs, American industry will encounter rough going in the post war world, and individual companies will find that profits do not flow to the inefficient. By causing contractors to think again of cost control, renegotiation can help them prepare for operating in an economy where sheer productive capacity does not guarantee a handsome return.

The historical-minded will recall that the Dutch Empire went into eclipse. As for the causes, it just could be that George Canning knew what he was talking about.